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An empirical analysis of the changes in tax audit focus on international transfer pricing

K. Hung Chan[a], Agnes W.Y. Lo[a,*], Phyllis L.L. Mo[b]

[a] Department of Accountancy, Lingnan University, Tuen Mun, Hong Kong
[b] Department of Accountancy, City University of Hong Kong, Kowloon Tong, Hong Kong

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ABSTRACT

International transfer pricing is an important financial management mechanism allowing multinational corporations to maneuver funds internationally. The manipulation of reported profits often triggers investigations from tax authorities. With the increased globalization of economies and changes in the business environment, tax authorities in many countries have refined their enforcement of transfer pricing regulations. In this study, we use archival data in China to examine whether tax authorities have changed their focus on auditing multinational companies over the past two decades. Our results indicate that Chinese tax authorities have significantly reduced their focus on auditing wholly foreign-owned enterprises, and placed more focus on Western multinationals and larger companies in the late 2000s as compared with tax audits in the early 1990s. Tax audits in the late 2000s also focus on export-oriented and loss firms. The findings show that changes in the business environment, regulations and the audit expertise of tax officials can lead to a shift in the focus of tax audits of international transfer pricing.

1. Introduction

This study provides empirical insights into transfer pricing audit focus in China. We examine firm characteristics that affect the probability of firms being selected for transfer pricing audit and investigate whether there is any longitudinal change in tax authorities' audit selection focus over the past two decades.

International transfer pricing has long been regarded as an important financial management mechanism for multinational corporations (MNCs) to maneuver funds internationally and to choose the countries in which profits are reported. MNCs frequently use transfer pricing as a means of reducing global income tax payments. Since 1995, biennial surveys conducted by Ernst & Young (2012) have found that transfer pricing continues to be rated by management of MNCs as the most important international tax issue. According to the Ernst & Young survey, the risk of transfer pricing audits is increasing and MNCs expect to devote more resources to transfer pricing compliance, particularly in China, the U.S. and India. According to a Deloitte webcast survey in 2012, 35 percent of MNCs reported that they had a Chinese affiliate that had undergone a transfer pricing audit within the past three years (Bell, 2012).

Tax authorities consider transfer pricing the most common form of tax avoidance by MNCs. This form of tax avoidance costs China an annual RMB 30 billion (US$4.7 billion) loss in tax revenue and Chinese tax authorities have stepped up

* Corresponding author. Tel.: +852 2616 8163; fax: +852 2466 4751.
E-mail address: wylo@ln.edu.hk (A.W.Y. Lo).

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measures to combat such tax avoidance (Pappas, 2012). China is one of the particularly dangerous zones for MNCs because Chinese tax authorities very likely impose penalties after an audit. According to Ernst & Young (2012), more than three-quarters of firms in China with transfer pricing audit adjustments had to pay penalties, and the average penalty rate was 25 percent of the additional tax. Given these financial implications, it is important that MNCs understand how Chinese tax authorities select transfer pricing audit targets and how this selection changes over time.

China has systematically liberalized its foreign direct investment regime since 1979. For example, in the mid-1990s, the Chinese government extended some of the special provisions used to attract foreign direct investment in special economic zones to other locations across the country. After China's admission to the WTO in 2001, many sectors, such as power generation, transportation, port development, oil exploration and exploitation, which were previously restricted, are now open to foreign investors. As a result, according to Zhang (2006), there have been significant changes in the characteristics of foreign investment in China since the early 1990s. Changes identified by Zhang (2006) include (1) investment by large MNCs has grown rapidly, with over 80 percent of all Fortune 500 companies now having established operations in China; (2) the entry mode of many MNCs has shifted from joint ventures to wholly foreign owned projects; (3) while small-scale, labor-intensive, and export-oriented foreign direct investment projects were dominant in the 1980s and the early 1990s, large-scale, capital- and technology-intensive, and local market-oriented foreign direct investments have increased substantially; and (4) while the majority of foreign direct investment is still from Hong Kong and Taiwan, the proportion of foreign direct investment from these sources has been reduced from about 80 percent to 60 percent in the past 15 years.

Chan and Chow (1997a) provided the first empirical study on transfer pricing audits in China during 1992–1993. Tax audit focus was measured by the difference between the audited samples and their respective population distributions in the early 1990s. Chan and Chow's univariate tests showed that transfer pricing audits in China were confined mainly to small-sized companies and transfer of tangible goods. Tax authorities also tended to focus on auditing Hong Kong–Taiwan sourced companies and wholly foreign-owned companies (WFOEs). Given deepening economic reforms, changes in the business environment and regulations, and a greater ability of enforcing transfer pricing regulations by Chinese tax authorities in the past two decades, we expect corresponding changes in tax authorities' focus on auditing foreign investment enterprises (FIEs) for transfer pricing. In this paper, we update and extend Chan and Chow (1997a) by assessing audit focus in 2006–2010 and comparing it with the results from 1992 to 1993 to identify any longitudinal changes. Our results show that audit focus on Hong Kong–Taiwan sourced FIEs and small FIEs has been reduced significantly, suggesting more audit efforts toward large Western FIEs (mainly U.S. and Japanese FIEs) in the 2000s. Moreover, tax authorities no longer focus on auditing wholly foreign-owned FIEs. Indeed, for foreign investors, the form of investment should no longer be a concern. Instead, in the late 2000s, tax audits focus on export-oriented and loss firms.

This paper contributes to the literature on tax audits and planning and should enhance MNCs' awareness of the changing risk of international transfer pricing audits. Increasing pressure on governments to raise revenue and the dedication of additional resources for transfer pricing enforcement lead to increasing efforts on tax audits often resulting in additional tax assessment and penalties. In China, once a firm is selected for transfer pricing audit, an adjustment of taxable income almost always results (Chan & Lo, 2005). Therefore, greater knowledge about transfer pricing audit focus, should enable MNCs to tailor their financial management, investment and transfer pricing strategies to minimize the probability of being audited, reduce tax costs, and improve the quality and quantity of documentation to support their related party dealings.

The remainder of this paper is organized as follows. Section 2 discusses changes in the Chinese business environment related to transfer pricing in the past two decades. Section 3 formulates the research hypotheses. Section 4 explains the research design, and Section 5 provides empirical results. The last section concludes.

2. Changes in the business environment in China during 1991–2010

2.1. The growth of foreign investment and trade in China

China has experienced rapid growth in GDP and foreign direct investment in the past two decades. The average annual GDP growth rate in China was about 9 percent for 2001–2010 (IMF, 2004, 2010). Foreign direct investment inflows to China reached US$105.7 billion in 2010, making China the largest recipient of foreign direct investment in the developing world (UNCTAD, 2011). In 2010, China became the largest export nation and the second largest import nation (behind the U.S.) in the world (IMF, 2011). FIEs in China play an increasingly important role in its foreign trade. In 2010, total imports and exports by FIEs accounted for 52.9 percent and 54.6 percent of China's total imports and exports, respectively (MOC, 2012). Related-party transactions between FIEs in China and their overseas affiliated companies have traditionally accounted for a large proportion of these import and export transactions. Chan and Chow (1997b) find that 88 percent of export-oriented FIEs in China trade with their overseas related companies for more than 70 percent of their total imports and exports. For non-export-oriented FIEs, 53 percent have more than half of their imports from their related companies. Chan and Lo (2004) report that 80 percent of their sample FIEs had inter-affiliate trade accounting for more than 75 percent of their total trade. In the 2000s, there has been a significant increase in China's outward direct investment, often in partnership with MNCs; the average growth rate for outward direct investment is 55 percent for 2003–2009 (Wang & Wang, 2011). This outward direct investment should further increase related party transactions between companies in China and their overseas affiliates. Due to the significant amount of related-party transactions of FIEs, international transfer pricing is a very important issue in China for both the Chinese government and the MNCs invested there. Consequently, tax avoidance through transfer pricing